

**Office of Chief Counsel
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memorandum**

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subject: Deductibility of Certain Expenses and Losses of a Qualified Settlement Fund

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Entities =
Receivership =

Receiver =
Business =

Year 1 =
Year 2 =
Date 1 =
Date 2 =

ISSUES

1. Whether Receivership, a Qualified Settlement Fund (QSF), may deduct, under § 1.468B-2(b)(2), interest expense and certain operating expenses that are necessary

to maintain commercial real estate properties (properties) during the court-approved process of liquidating all its assets for distribution.

2. Whether Receivership may deduct, under § 1.468B-2(b)(3), losses sustained from the disposition of the properties during the liquidation process.

3. Whether Receivership may take losses sustained from disposition of the properties into account in calculating a net operating loss under § 1.468B-2(b)(4).

CONCLUSIONS

1. The interest expense and operating expenses that are necessary to maintain the properties during the court-approved process of liquidating all Receivership's assets for distribution are administrative costs or other incidental expenses that are deductible in calculating modified gross income under § 1.468B-2(b)(2).

2. During the court-approved process of liquidating all its assets for distribution from the QSF, Receivership is not operating a trade or business. Thus, the properties are capital assets, and losses sustained from their disposition are deductible in calculating modified gross income under § 1.468B-2(b)(3), to the extent allowed under §§ 1211(a) and 1212(a).

3. Receivership may take losses sustained from disposition of the properties into account to the extent such losses are allowed under § 1.468B-2(b)(3) in calculating a net operating loss under § 1.468B-2(b)(4). However, because the losses are capital losses rather than ordinary losses, such losses may be deducted only to the extent allowed under §§ 1211(a) and 1212(a).

FACTS

In Year 1, the Securities and Exchange Commission (SEC) filed a civil enforcement action against Entities and certain individual defendants alleging violation of federal securities laws. The court granted the SEC's request for the appointment of Receiver as receiver for Entities, which were part of a complex Ponzi scheme that defrauded numerous investors.

The court order authorized Receiver to, among other things: (1) take and retain immediate possession and control of all of the assets of Entities and all other entities they control or in which they have an ownership interest; (2) succeed to all rights to manage real estate properties owned or controlled by Entities; (3) pay from available funds necessary expenses required to preserve the assets; (4) make and authorize in the ordinary course payments from the funds under his control, incur expenses and enter into agreements as reasonably necessary or advisable under the circumstances; and (5) use, lease, sell and convert into money all assets of Entities on terms Receiver reasonably believes to be most beneficial to Entities and those entitled to the proceeds.

At the time Receiver took control of the assets of Entities, many of Entities were engaged in the operation of an ongoing, active Business. Because of the level of disruption in the real estate markets in Year 1 and Year 2, Receiver determined that an orderly liquidation of the assets was in the best interests of defrauded investors and unsecured creditors. This process required Receiver to hold the real estate assets until they could be sold for prices that better reflected their fair value in a properly functioning, liquid market.

Receiver filed a plan for the management of Entities' real estate assets with the court on Date 1. Receiver stated therein that his principal objective in managing the assets of Entities was to preserve the value of those assets for the benefit of all interested parties, and to preserve the court's ability to approve a fair distribution of the remaining assets to the victims of the scheme alleged in the SEC's complaint. The plan contemplated that many of Entities' properties would be sold at fair market value, and that the marketing and sale process would be designed to preserve the value of the estate and avoid a fire sale of the assets.

From the time of Receiver's appointment and in accordance with the plan of distribution, Receiver has continued to operate the commercial real estate properties until the properties could be disposed of in accordance with the plan. As of Date 2, Receiver had relinquished ownership of numerous commercial real estate properties with respect to which there was no expectation of a net cash recovery for Receivership in light of existing debt encumbrances. These relinquishments turned the properties over to secured creditors, and released Receivership from the related debt encumbrances. As of Date 2, Receivership consisted primarily of seven commercial real estate properties.

Receivership has incurred interest expense and various types of other expenses necessary to maintain and preserve the value of the commercial real estate properties (collectively, the operating expenses) pending the orderly sales of the properties in accordance with the court-approved plan of distribution. The operating expenses include: (1) cleaning; (2) repairs and maintenance; (3) security; (4) landscaping; (5) utilities; (6) meals and entertainment; (7) administrative and miscellaneous; (8) payroll expenses (including payroll taxes); (9) insurance; (10) consulting expense; (11) management fees; (12) lease commission payments; and (13) property taxes, franchise taxes and excise taxes.

Receivership asserts that the interest expense and operating expenses are deductible under § 1.468B-2(b)(2). Receivership further maintains that losses sustained from the disposition of the properties during the liquidation process are deductible without limitation as ordinary losses under § 1.468B-2(b)(3). Finally, Receivership asserts that such losses may be likewise deducted without limitation in calculating a net operating loss under § 1.468B-2(b)(4).

LAW AND ANALYSISIssue 1

The first issue is whether Receivership may deduct, under § 1.468B-2(b)(2), the interest expense and operating expenses.

Section 1.468B-2(a) provides that a qualified settlement fund is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e).

Section 1.468B-2(b) provides that the modified gross income of a qualified settlement fund is its gross income, as defined in § 61, computed with certain modifications.

Section 1.468B-2(b)(2) allows a deduction for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of, claimants.

Receiver was ordered by the court to take possession and control of all of the assets of Entities. These assets included real property that was heavily encumbered by debt and used in Business. Due to the level of disruption in the real estate markets, Receiver and the court determined that it was in the best interest of Receivership and defrauded investors to hold the real estate assets until the markets recovered sufficiently for the properties to be liquidated in an orderly market sale process. The plan of distribution called for continued operation and preservation of the assets to facilitate an orderly liquidation and distribution of final net proceeds to defrauded investors. The properties were no longer used in a trade or business because the properties were held in the QSF merely for liquidation and distribution, as discussed below under Issue 2. Under these circumstances, the interest expense and operating expenses were necessary expenses incidental to the purposes of Receivership; namely, the administration, preservation and realization of the value of the assets the Receiver was ordered to take control of for the benefit of the defrauded investors and distribution of the net recovered amounts to those investors.

We conclude that, under the circumstances in this case, the interest expense and operating expenses that are necessary to maintain the properties during the court-approved process of liquidating all of Receivership's assets for distribution are administrative costs or other incidental expenses that are deductible in calculating modified gross income under § 1.468B-2(b)(2).

Issue 2

The second issue is whether Receivership may deduct, under § 1.468B-2(b)(3), losses sustained from the disposition of the properties during the liquidation process.

Section 1.468B-2(b)(3) allows a deduction for losses sustained by the qualified settlement fund from the sale, exchange or worthlessness of property held by the fund to the extent the losses would be deductible in determining the taxable income of a corporation under § 165(f) or (g), and §§ 1211(a) and 1212(a).

Section 165(f) provides that losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212.

Section 1211(a) provides that in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

Section 1212(a)(1) provides, in relevant part, that corporate taxpayers can carry net capital losses back to the three taxable years preceding the loss year and then forward to the five taxable years succeeding the loss year. The carryback of a net capital loss does not increase or produce a net operating loss (as defined in § 172(c)) for the taxable year to which it is being carried back.

Section 1221(a) provides that the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), with the exception of the items described by §§ 1221(a)(1) through 1221(a)(8), including property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, depreciable property used in the taxpayer’s trade or business, or real property used in the taxpayer’s trade or business.

The Supreme Court has defined a trade or business as an activity conducted with continuity and regularity and with a primary purpose of making income or a profit. Commissioner v. Groetzinger, 480 U.S. 23, at 32, 35 (1987).

The objective of Receivership was the orderly liquidation of the real estate in the QSF. Unlike an activity entered into for profit, Receiver’s goal is to preserve and manage such properties until such time as the assets could be liquidated in an orderly manner at fair value as so approved by the court. Thus, at the time Receivership was ordered and became a QSF, it was no longer operating Business as a trade or business, and the assets were no longer property used in a trade or business.

Receiver’s principal objective in managing Receivership’s assets was to preserve the value of those assets for the benefit of all interested parties, and to preserve the court’s ability to approve a fair distribution of the remaining assets to the victims. Once the real estate markets had recovered sufficiently, it was Receiver’s intent to effectuate a fair

distribution of assets by selling the assets at a market value sufficient to compensate the victims.

We conclude that the assets are capital assets under § 1221, and that losses sustained from their disposition are deductible in calculating modified gross income under § 1.468B-2(b)(3), to the extent allowed under §§ 1211(a) and 1212(a).

Issue 3

The third issue is whether Receivership may take losses sustained from disposition of the properties into account in calculating a net operating loss under § 1.468B-2(b)(4).

Section 1.468B-2(b)(4) allows a deduction for the amount of a net operating loss (NOL) of a QSF to the extent the loss would be deductible in determining the taxable income of a corporation under § 172(a). For this purpose, the NOL of a QSF for a taxable year is the amount by which the deductions allowed under §§ 1.468B-2(b)(2) and 1.468B-2(b)(3) exceed the modified gross income of the fund as computed under § 1.468B-2(b)(1).

Ordinary losses that arise from the sale, exchange or worthlessness of property are not deductible under § 1.468B-2(b)(3); thus, ordinary losses are not taken into account in calculating an NOL under § 1.468B-2(b)(4). Section 1.468B-2(b)(3) only allows for the deduction of capital losses.

We have concluded in Issue 2, above, that the losses incurred by Receivership from the disposition of commercial real estate properties are deductible as capital losses under § 1.468B-2(b)(3). Accordingly, Receivership may deduct capital losses to the extent of its capital gains under § 1211(a), and capital losses in excess of capital gains in a taxable year may be carried back or forward under the rules of § 1212(a)(1). In calculating an NOL and in order to comply with the foregoing deduction limitations regarding capital losses contained in § 1.468B-2(b)(3), Receivership must segregate capital gains and losses from the other elements of modified gross income. Due to the capital loss deduction limitations prescribed in § 1.468B-2(b)(3), Receivership may not take into account excess capital losses sustained from disposition of the properties in calculating an NOL for a taxable year under § 1.468B-2(b)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call me or Steve Gee at (202) 622-4970 if you have any further questions.